

their long-distance affiliates with excess revenues derived from local service rates obtained by misallocation of long-distance costs. Although Dr. Schwartz recognizes that even detailed accounting requirements have been unable to eliminate cost misallocation in the past, and that it is naive to assume they could do so in the future, Schwartz Aff. p. 38, he relies on price cap regulation as a safeguard. Dr. Schwartz fails to address, however, that a number of state commissions have not embraced pure price cap regulation.¹⁰ Moreover, experience suggests that even those state commissions that have adopted pure price caps will shelter an incumbent that suffered an *apparently* “bad” year by raising the price cap for the future. In its recent order, the Commission itself held open the possibility that the BOCs could secure a higher price cap for access charges after a bad year, while rejecting any possibility for any downward adjustment in the cap if BOCs continued to earn supracompetitive profits on access.¹¹ Either situation provides incumbents with opportunities and incentives to allocate costs so as to obtain inflated local revenues with which to subsidize entry into long distance.

The resulting harms are detailed by Dr. Schwartz: consumers pay higher prices for regulated local service; incumbent local exchange carriers (“ILECs”) are given the incentive to allocate resources and common costs in order to generate excessive common costs for monopoly

¹⁰ Indeed, Oklahoma will continue to use a rate-of-return pricing methodology, not price caps, at least through 1997. The Oklahoma Commission has not yet determined what framework will be used thereafter. Thus, SWBT will have every opportunity and incentive to misallocate costs and misuse excessive local revenues to subsidize its long-distance affiliate.

¹¹ See *In re: Access Charge Reform, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, ¶¶ 127, 144-62 (FCC 97-159 Rel. May 21, 1997).

services, rather than the incentive to provide efficient service; as a result, competition in long-distance service is distorted. *See* Schwartz Aff. p. 38 & n.39. In contrast, local competition provides a restraint on such anticompetitive behavior because it imposes a penalty for excessive local rates: customers will switch to other local carriers. Thus, the opportunities for BOCs to misallocate long-distance costs as local costs, absent meaningful local competition, further argues for ensuring that such local competition exists before impairing what Dr. Schwartz himself acknowledges is a well-functioning long-distance market.

Second, Dr. Schwartz recognizes that the best course for maintaining healthy competition in the long-distance market is “to reduce access charges closer to cost.” Schwartz Aff. p. 44. Although Dr. Schwartz recognizes that BOCs, unlike unaffiliated carriers, are not affected by inflated access charges because payment is simply a book-keeping entry for the BOCs, Schwartz Aff. p.42, he underestimates the ability of BOCs to use inflated access charges to squeeze out long-distance competition. His conclusion that the public interest would be served by BOC entry because it would permit *some* consumers to obtain lower prices, Schwartz Aff. p. 43, is contrary to the Act and fails adequately to take into account countervailing harms. Congress, in including non-discrimination and imputation requirements in section 272, clearly made the regulatory choice that the telecommunications market should operate on market factors, without distortions introduced by regulatory inequities. Section 272 incorporates a congressional policy requiring the BOCs to lower access charges for *all* long-distance customers if they lower them for the customers of their long-distance affiliates. Permitting BOC entry into long distance before local competition is developed to the point when other companies, as well as the BOCs, can avoid

above-cost access charges through meaningful vertical integration undermines Congress' purposes and is contrary to the public interest. Access-charge-based price squeezes by BOCs permit BOCs to gain customers because of a regulatory advantage, not because they are more efficient:

The IXCs are right that even if imputation rules required a BOC to charge its affiliate the same access price as it charges IXCs, an affiliate would treat such a price as merely an internal transfer, and would try to base its retail prices on the true cost of obtaining access. A BOC's affiliate would then be able to undercut IXCs' prices selectively to certain customers and capture such business *even if it is inherently less efficient than IXCs*.

Schwartz Aff. pp. 42-43 (emphasis added).¹² Thus, permitting BOCs into in-region long distance before local competition provides a check on such anticompetitive behavior not only fails to further Congress' purpose of introducing competition into formerly highly regulated services, it undermines Congress' purpose by introducing regulatory distortions into formerly market-driven long-distance services.

Finally, Dr. Schwartz recognizes that BOC entry into long distance would not be in the public interest where a BOC could impose higher access charges on competing IXCs than on its own affiliate, either through targeted discounts or through flexible price caps. Schwartz Aff. p.

¹² Dr. Schwartz correctly determines that the FCC's recent actions on access charges do not bring them down to cost "and in fact are likely to leave them well above costs for some time." Schwartz Aff. p. 42 n.47. Further, he explains that "intrastate access charges, which now typically exceed interstate charges, will remain under the jurisdiction of state commissions and considerable uncertainty remains about their levels." *Id.* Thus, the concerns raised by BOC manipulation of access charges survive the FCC's recent orders. Moreover, as noted above, the FCC's decision not to reduce access to cost gives interexchange carriers an enormous incentive to enter the local market -- an incentive that dwarfs any supposed benefit of avoiding entry in order to keep the BOCs out of long distance.

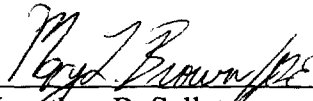
43. That the FCC has not yet determined precisely what flexibility the BOCs and other ILECs should have in setting access charges strongly suggests that the potential risks to competition in the long-distance market threatened by premature BOC entry cannot yet be fully determined and therefore cautions further against introducing such risks into long distance before the safeguards provided by local competition are reliably present.

CONCLUSION

For the foregoing reasons, and the reasons set forth in MCI's May 1 Comments, the Commission should deny SWBT's application to provide in-region interLATA services in Oklahoma.

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CERTIFICATE OF SERVICE

I, Jerome L. Epstein, hereby certify that the foregoing "Reply Comments of MCI Telecommunications Corporation" was served this 27th day of May, 1997, by the methods indicated below, upon each of the following persons:

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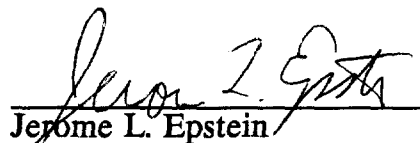
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